TÜRKİYE CUMHURİYET
MERKEZ BANKASI

HEAD OFFICE

ANKARA, 31 January 2017

Please refer to
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Mehmet ŞİMŞEK
DEPUTY PRIME MINISTER
ANKARA

As stipulated in the Article 42 of the Central Bank Law, in the case of a significant breach of the inflation target, the Central Bank of the Republic of Turkey (the Central Bank) is accountable for reporting to the Government and announcing to the public the reasons behind the breach of the target and the necessary measures to be taken. As stated in the main policy document titled "Monetary and Exchange Rate Policy in 2016", which was published on December 9, 2015; the inflation target for 2016 was set jointly with the Government as 5 percent. In the same document, it was also indicated that the Central Bank would write an open letter to the Government should end-year inflation exceed the target significantly (by more than 2 percentage points in either direction). Inflation reached 8.53 percent at end-2016, notably exceeding the target. This text elaborates on the reasons why the target was missed and explains the measures already taken—and to be taken—to bring inflation back to the target.

Factors Affecting Inflation in 2016

In the first Inflation Report of 2016 (IR 2016/I), the mid-point of the year-end inflation forecast was given as 7.5 percent. However, deviations from the underlying assumptions and developments affecting the dynamics of inflation through 2016 caused inflation to end the year at a higher rate.

The main factors causing inflation to breach the target in 2016 include tax adjustments, wage increases and the Turkish lira depreciation. The large minimum wage raise in early 2016 pushed the overall wage level higher, which affected consumer prices through both cost and income channels, while SCT adjustments for tobacco, alcoholic beverages, fuel and automobiles had a negative impact on inflation over the year. The fourth quarter's plunging Turkish lira and highly volatile exchange rates affected inflation not only through first-round cost pressures but also through expectations channel and the overall pricing behavior.

TÜRKİYE CUMHURİYET MERKEZ BANKASI A.Ş.
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SERMAYESİ: 25.000 TL
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Emerging market currencies have depreciated dramatically since mid-2013 amid heightened uncertainty over global monetary policies. Both this ongoing outlook and geopolitical developments of 2016 caused the Turkish lira to depreciate by about 11 percent against the foreign currency basket in 2016. A large part of this depreciation occurred in the final quarter, rendering the cumulative exchange rate pass-through less effective through the year. In fact, the annual core goods inflation remained on a marked downtrend until November, but started to climb by December due to the fourth-quarter TL plunge.

After dipping to an all-time low since 2004 in early 2016, oil prices had an increasing trend throughout 2016 and are up by more than 40 percent year-on-year in December. Additionally, the TL depreciation and the SCT hike on fuel led to a dramatic year-on-year increase in annual energy inflation. Despite higher electricity prices of early 2016, the total contribution from reduced natural gas prices and administered prices of energy was small.

Alcoholic beverages and tobacco made the fastest-growing contribution to inflation through 2016. Besides SCT adjustments in January and December, July price hikes by tobacco companies also stood out in this category. Thus, alcoholic beverages and tobacco pushed annual inflation up by 1.6 points.

Services inflation remained elevated over the year as well. Despite the downward pressure from the subdued economy, the tourism slump and the moderate food inflation, services inflation remained high amid soaring real unit wages, the tumbling Turkish lira and rising inflation expectations.

Meanwhile, food prices weighed on consumer inflation in 2016, contrary to previous years. Along with favorable supply conditions of agricultural products, the measures put into effect by the Food and Agricultural Products Markets Monitoring and Evaluation Committee, the dismal tourism industry and the glut caused by Russian sanctions helped annual food inflation to remain far below the historical averages.

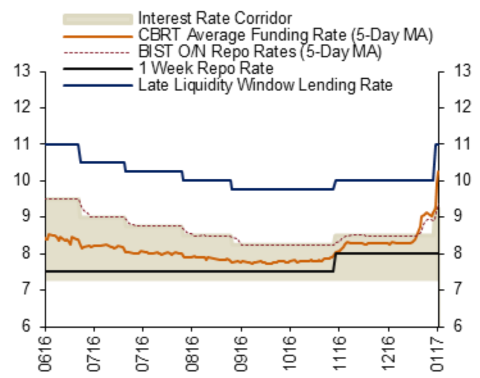
In sum, despite weaker domestic demand conditions and moderate food prices, inflation exceeded the target due to developments in exchange rates and import prices as well as adjustments in minimum wages and taxes. The lagged effects of the Turkish lira depreciation in the last few months, the course of oil prices and heightened medium-term inflation expectations place an upward pressure on the inflation outlook. On the other hand, the modest economic activity and the prediction that there will be no more upward adjustments on wage, tax and administered prices are estimated to bring inflation down in 2017.

Measures Taken to Reach the Inflation Target

Throughout the year, the Central Bank has shaped its monetary policy framework by taking into account inflation developments and expectations. Up until September, reduced inflationary pressures, tight financial conditions and mild global conditions enabled the Bank to gradually reduce the marginal funding rate. Accordingly, the marginal funding rate was lowered by a total of 250 basis points during the March-September 2016 period. From October onwards, however, the Bank has adopted a more cautious approach due to cost pressures stemming from rising oil prices and exchange rate. In this regard, after keeping the policy rates constant in October, the Bank raised both the weekly repo rate and the marginal funding rate in November, in order to contain the adverse impact of exchange rate movements, caused by heightened global uncertainty and volatility, on the inflation outlook. In addition, the Bank also tightened the liquidity policy by increasing the share of marginal funding in the total Central Bank funding. The same policy stance is maintained in December, in order to better assess the impact of weakening in economic activity on inflation.

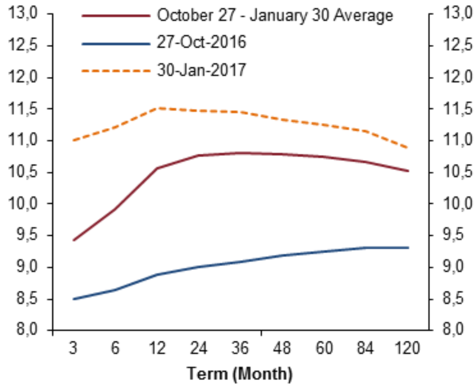
At the beginning of 2017, to avert the possible impacts of exchange rate volatility and unhealthy price formations diverging from economic fundamentals, the Bank has launched a policy framework which included dynamic and different liquidity instruments. Accordingly, the CBRT did not launch one-week repo auctions starting from 12 January 2017 and the banks' borrowing limits at the Interbank Money Market established within the CBRT were reduced. On the days deemed necessary as of January 16, the amount of funding provided by the CBRT through Borsa Istanbul repo markets was limited. Additionally, foreign exchange reserve requirement ratios have been reduced by 50 basis points for all maturity brackets. Moreover, to enhance flexibility and instrument diversity of the Turkish lira and FX liquidity management within the current monetary and exchange rate policy framework, Foreign Exchange Deposits against Turkish Lira Deposits market was opened on 17 January 2017.Excessive fluctuations in exchange rates weighed on upside risks to the inflation outlook. Due to lagged effects of these developments and the volatility in unprocessed food prices, the hikes in inflation are expected to continue in the short term. Accordingly, the Bank decided to strengthen the monetary tightening to contain the deterioration in inflation outlook. Thus, in January 2017, the marginal funding rate was raised from 8.5 percent to 9.25 percent, and the CBRT's borrowing rate under the Late Liquidity Window Facility, was increased from 10 percent to 11 percent (Chart 1).

Chart 1
CBRT Rates and BIST Interbank O/N Rates (Percent)



Source: BIST, CBRT.

Chart 2
Currency Swap Rates
(Percent)



Source: CBRT.

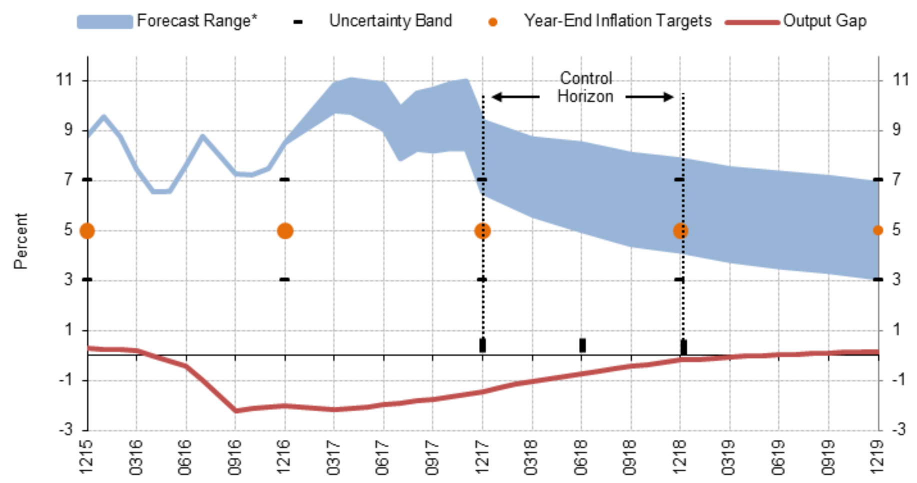
The initial effects of the monetary tightening have been extremely powerful. Owing to the Central Bank policies, the depreciation trend in the Turkish lira has come to a halt and the yield curve has flattened (Chart 2).

In addition to the interest rate and Turkish lira liquidity actions, the Central Bank also took measures to support the foreign exchange liquidity; in response to the exchange rate volatility realized in the second part of 2016. In this respect, the bank has provided extra foreign exchange liquidity to the financial system, by gradually reducing the foreign exchange reserve requirements and the reserve option coefficients. Furthermore, in order to enhance the flexibility of the FX liquidity management of banks, the average amount of reserve requirements that banks can hold in the maintenance period was raised to 4 percent from 3 percent. In addition, arrangements were made to extend the maturity of the export rediscount credits and to make their repayment in Turkish liras until the end of the year. Measures such as reimposing the cap on FX collateral deposits and partial provision of the FX liquidity needs of energy importing public firms by the CBRT and the Treasury also supported the foreign exchange liquidity in the market.

In sum, throughout 2016, in order to limit the adverse effects of volatilities in the global and domestic financial markets, the Bank has maintained its stance that aims to balance foreign exchange liquidity and support financial stability.

Given a tight policy stance that focuses on bringing inflation down, the 5-percent target is expected to be achieved gradually; inflation is likely to stabilize around 5 percent as of 2019 after falling to 8 percent in 2017 and to 6 percent in 2018 (Chart 3). Assumptions on which the predictions are based coupled with the risks to the inflation outlook are elaborated on in the January 2017 Inflation Report.

Chart 3
Inflation and Output Gap Forecasts



* Shaded area denotes the 70 percent confidence interval for the forecast.

Conclusion

The Central Bank will continue to employ all tools at its disposal to achieve the main objective of price stability. Monetary policy decisions will be dependent on the inflation outlook in the period ahead. By closely monitoring the inflation expectations, pricing behaviors and developments in other factors affecting inflation additional monetary tightening may be implemented if deemed necessary. Moreover, necessary measures will be taken against unhealthy price formations in the foreign exchange market that are inconsistent with economic fundamentals.

Although the monetary policy framework contribute to fighting against inflation, experiences under the inflation targeting regime point to the need of a joint effort in maintaining permanent price stability. In recent years, concurrent shocks and structural factors kept inflation volatile and above the target. In achieving permanent price stability, it is important to enhance cooperation and coordination among relevant institutions. Accordingly, the Food and Agricultural Products Markets Monitoring and Evaluation Committee constitutes a valuable example. The recently pronounced efforts to manage foreign exchange risk from a financial stability perspective will support the effectiveness of the monetary policy and the fight against inflation. In addition, enhancing the coordination between monetary and fiscal policies will also support the struggle against inflation.

The January 2017 Inflation Report, published on our website today, which comprehensively presents the developments regarding inflation and monetary policy as well as our medium-term forecasts, is enclosed for your information.

Yours Sincerely,

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Murat Çetinkaya
Governor

Murat Uysal
Deputy Governor

Enc: January 2017 Inflation Report

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